

## **A Literature Review on Banks' Profitability and Risk Adjustment Decisions**

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**Abstract :** There are pending discussions over an impact of global regulatory efforts on banks. In this paper we present a literature review on the profitability-risk-capital relationship in banking. Research papers dealing with this topic can be divided into two groups: the first group focusing on a capital-risk relationship and the second group analyzing a capital-profitability relationship. The first group investigates whether the imposition of stricter capital requirements reduces risk-taking incentives of banks based on a simultaneous equations model. Their model pioneered the idea that the changes in both capital and risk have endogenous and exogenous components. The results obtained by the authors indicate that changes in the capital level are positively related to the changes in asset risk. The second group of the literature concentrating solely on the relationship between the level of held capital and bank profitability is limited. Nevertheless, there are a lot of studies dealing with the banks' profitability as such, where bank capital is very often included as an explanatory variable. Based on the literature review of dozens of relevant papers in this study, an empirical research on banks' profitability and risk adjustment decisions under new banking rules Basel III rules can be easily undertaken.

**Keywords :** bank, Basel III, capital, decision making, profitability, risk, simultaneous equations model

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